June 1997
(original printing)
About Beacon Financial Advisors Ltd.

Beacon is an independent fee-only advisor with a clear mission statement: To provide our clients long-term value-added financial counsel and investment performance with *exceptional service.*

Beacon is a Registered Investment Advisor with the US Securities and Exchange Commission.

Beacon's Advisors

MARCEL HEBERT has a B.S. in Finance, an M.B.A., and is a Certified Financial Planner (CFP) licensee and a Chartered Financial Analyst (CFA) charterholder.

JOSH HEBERT has a B.S. in Accounting, an M.B.A., and is a Certified Internal Auditor (CIA) and a Certified Financial Planner (CFP) licensee.

CHARTING THE COURSE

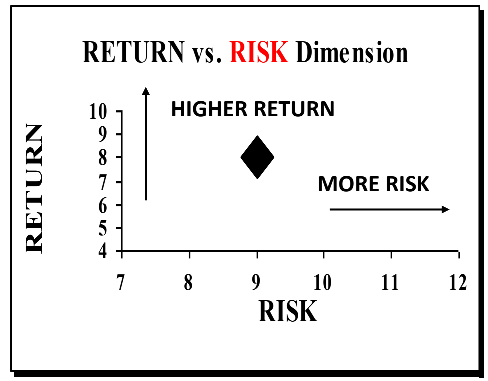
Special Series of Briefs About Beacon's Client Services

HOW MANY MUTUAL FUNDS ARE ENOUGH? *A Look At Risk Reduction*

Academics and investment practitioners have long studied and debated the issue of how many stocks, selected at random, make for a diversified portfolio. A *diversified portfolio*, simply put, is one which enjoys risk-reduction with each additional investment. Even with the explosion of the number and use of mutual funds over the past several years, there is a notable lack of research into the *diversified portfolio* question using mutual funds.

Unlike other great philosophical questions that man has studied for eons (e.g. How much wood could a woodchuck chuck...etc?), the question of building a *diversified portfolio* has PRACTICAL relevance to clients of **BEACON.** In previous client communications, we have written often about WHY and HOW **BEACON** uses mutual funds to construct client portfolios. **In this SERVICE BRIEF, we want to focus our attention on why Beacon uses more than just a handful of mutual funds in constructing each clients' portfolio.** To borrow a concept from our 20-page white paper BALANCED, GLOBAL PORTFOLIOS USING MUTUAL FUNDS (Pick The Players, Step 3, p. 8), we emphasize Beacon's 4-Fold Safety Net diversification strategy as follows:

- ⇒ MULTIPLE ASSET CLASSES
- ⇒ GEOGRAPHIC SPREAD
- ⇒ SECTOR (INDUSTRY) SPREAD
- ⇒ MANAGER-STYLE



Our white paper further states ***"It is typical that a fully-invested client portfolio will have from twelve to twenty-plus separate funds in the various asset classes to meet our 4-Fold Safety Net standard."*** **Beacon's** multi-asset class, multi-fund approach is not typical and some practitioners and financial journalists are critical of our approach*. Yet, our approach has merit and is getting some academic validation as we'll see later (*note: this was true in 1997's original printing in our Summer 1997 issue of ON WATCH; however our approach has been much more widely-adopted by more practitioners).

Before delving much further into the question of HOW to diversify, it is important again to remind clients about WHY we diversify. **BEACON** uses diversification to *control volatility,* and by doing so enhance the odds of building a capital base to achieve each clients' financial objectives. Stated another way, **BEACON** uses diversification to *limit losses* (*losses* can occur in what are known as poor financial markets....since we haven't had one in a while, some clients may find *losses* a strange concept). As discussed in our many client communications about volatility and risk, the most important factor influencing terminal (ending) wealth is not the annual rate of return achieved but the *risk-adjusted* annual rate of return realized. **Two investors can begin with the same wealth, experience the same average annual returns, and yet have dramatic differences in terminal wealth if their annual volatility measures differ.**

HOW MANY MUTUAL FUNDS ARE ENOUGH? *A Look At Risk Reduction*

Having cited the scarcity of research into the question of how many mutual funds benefit investors, a significant article by Professor Edward S. O'Neal appeared in the March/April 1997 issue of Financial Analysts Journal—How Many Mutual Funds Constitute a Diversified Mutual Fund Portfolio. O'Neal's central thrust in his research effort was to evaluate how the addition of each additional mutual fund impacted the variability (change) in terminal wealth. O'Neal wrote, ***"Two investors with identical [time] horizons but different investments will likely achieve different terminal-wealth levels. This variability in terminal wealth, caused by holding different investments, is of prime interest, especially to long-term investors."***

BEACON'S clients are more interested in long-term goal achievement than with monthly or quarterly shortfalls. To illustrate, our Investment Policy Statement questionnaire poses a series of questions designed to elicit preferences and priorities from new clients. One question asks new clients to rank the risks they most want to AVOID, and it is typical that "Not achieving expected total return over the long-term" is the top priority of new clients. Restated, our clients are MORE concerned with having enough wealth to finance their lifetime financial objectives THAN WITH outpacing the Dow Jones Averages (and rightly so!).

Now, **BEACON'S** approach of using multi-asset classes, multi-funds has received some solid academic research support. Professor O'Neal's study shows that holding more than a single mutual fund in a portfolio appears to have substantial diversification benefits (via risk reduction). As the chart below demonstrates, this benefit is greatest with the addition of small numbers of funds (steep downward slope) yet the risk-reduction attributes continue as more funds are added. And, the benefits consistently appear in different holding periods from 5 to 20 years. As the chart heading indicates, Professor O'Neal used Morningstar's Growth & Income category (representative of high-dividend stocks). We believe the results might be even better if the categories under study were expanded to include, bonds, foreign stocks, real estate stocks, etc. Thanks, Professor O'Neal!